structure for areas served by rural ILECs, as well as for non-rural ILECs, should include inducements for the ILECs and their state regulators to eliminate implicit support from their rate structures. By adopting a structure such as Qwest's two-tier proposal, the Commission would ensure that every state receives a reasonable amount of support, and the threat of depriving the state and its carriers of that support would establish an inducement to eliminate implicit subsidies

Western Wireless submits that the Commission should limit ILEC high-cost support unless their basic retail rates for residential universal service recover at least a minimal amount of revenue corresponding to an "affordable" rate under the statute 85/ Rural ILECs typically recover 50% to 75% of their revenues from universal service funding and access charges, not from their own customers; and a significant number of those carriers maintain unreasonably low retail rates 86/ Not only does this unhealthy dependence on high-cost support and access charges insulate these carriers from any incentive to be responsive to their own consumers' needs. It also means that, in cases where retail rates are extraordinarily

85/ This proposal is different from, and distinguishable from, SBC's proposal regarding an "affordability benchmark" for each geographic area, which the Commission rejected in the *Tenth Circuit Remand Order*, ¶ 45 SBC proposed setting high-cost support based on the difference, in each geographic area, between the forward-looking cost of service and an affordability benchmark determined based on a percentage of average household expenditure levels *See* SBC Comments, CC Docket No 96-45, at 15-16 (filed Dec 20, 2002) By contrast, Western Wireless' proposal here would simply preclude the disbursement of federal support to carriers that recover unreasonably low rates, below minimal "affordable" levels, from their end-users, in order to protect consumers across the country from providing unreasonable subsidies to such carriers The Commission should seek comment on specific implementation issues related to this proposal, such as the definition of "affordable" rate levels in each geographic area

86/ *See, e g* , Fred Williamson & Assocs , Inc , Comments, CC Docket No 96-45 (Joint Board Portability Proceeding) (filed May 5, 2003), at 11-12 (certain rural ILECs in Kansas receive only 17% of their revenue per access line from their end-user customers, and the remainder from interstate and intrastate access charges and universal service funds) low, consumers around the country, who pay into the high-cost fund, are being forced to provide unfairly generous subsidies

To be sure, rural consumers are entitled under the Act to rates that are "affordable" and "comparable" to rates available elsewhere, with the support of the federal high-cost universal service program But they are not entitled to subsidized rates *below* affordable and comparable levels. Such unreasonably low retail rates, maintained through regulatory policies, also pose a barrier to competitive entry.

Accordingly, Western Wireless submits that, in order to create inducements to eliminate implicit subsidies, the level of federal universal service support available to a carrier would be based upon whether a carrier's retail rates are at or above an "affordability" benchmark. 87/ Carriers whose basic retail rates are below that benchmark would be limited in the amount of support they are eligible to receive

V. THE COMMISSION SHOULD ESTABLISH RULES THAT GRADUALLY PHASE IN THE NEW FORWARD-LOOKING COST-BASED SYSTEM AND PROVIDE FOR A REASONABLE TRANSITION

Western Wireless recognizes that it is proposing a significant transformation in the high-cost universal service system and in the way rural ILECs are regulated. Accordingly, Western Wireless believes that a gradual transition plan is appropriate, as follows

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87/ *See, e g*, Sprint Comments, CC Docket No 96-45 (Joint Board Portability Proceeding) (filed May 5, 2003), at 15-19

First, the new rules should not become effective until 2006, upon the expiration of the five-year period provided by the *RTF Order*, and should apply initially only to competitive ETCs, non-rural ILECs, and rural ILECs owned by relatively large holding companies The rules should be phased in more gradually for smaller rural ILECs Second, a transitional mechanism should be established such that no carrier's high-cost support is reduced by more than 20% in any one funding year Third, a "safety net" should be available under which a carrier could show, using clear criteria established in advance, that it needs additional support to avoid hardship

In the *RTF Order*, the Commission determined that the key elements of that plan would remain in place for a five-year stability period, running through mid-2006 88/ Similarly, in the *MAG Order*, the Commission concluded that the key features of the access charge reform plan adopted in that order should remain in place for the same five-year period. 89/ Western Wireless believes that the Joint Board and the Commission must keep their promises and deliver the regulatory stability that they promised to ILECs and competitive ETCs alike, which is crucial for investment and economic decision-making. However, it is certainly timely for the Commission to begin now to lay the groundwork necessary to begin eliminating

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88/ *RTF Order*, 16 FCC Rcd at 11309-10, ¶ 167

89/ *MAG Order*, 16 FCC Rcd at 10, ¶ 15

rate-of-return regulation as of the end of the 5-year RTF stability period, as was presaged in the *RTF Order* 90/

Western Wireless proposes that the new system of high-cost universal service funding and interstate access charge regulation be introduced in 2006, at the end of the five-year period of the RTF plan, and phased in gradually thereafter. Specifically, in 2006, the new universal service system should apply only to competitive ETCs, non-rural ILECs; and rural ILEC study areas with 100,000 or more lines in all affiliated study areas nationwide and/or 30,000 lines or more in all affiliated study areas statewide The plan would be extended in 2008 to rural ILEC study areas with 50,000 or more lines in all affiliated study areas nationwide and/or 15,000 or more lines in all affiliated study areas statewide, and in 2010 to rural ILEC study areas with 20,000 or more lines in all affiliated study areas nationwide and/or 5,000 or more lines in all affiliated study areas statewide The plan would not be applied to the smallest rural ILECs until 2012.

In order to prevent "rate shock" to carriers whose support payments are reduced, Western Wireless suggests that, in addition to the gradual implementation schedule proposed above, the plan be implemented in such a way that no ILEC study area loses more than a specified percentage (20 or 25 percent) of the amount of support it previously received in any one year "Hold-harmless" support should be made available, in addition to the forward-looking cost-based support, to ease the transition process Competitive ETCs operating in such a study

90/ *See RTF Order*, 16 FCC Rcd at ¶ 12

area would receive a comparable amount of portable support (on a per-line basis) for each customer connection they serve

Furthermore, as in the RTF plan, Western Wireless believes that a "safety net" supplementary support mechanism should be available If a carrier can prove that, in its particular circumstances, the amount of support is not sufficient to provide the basic universal services, an additional safety net or supplemental mechanism should be available for a limited period of time Specific criteria for such supplemental support would have to be adopted in advance. This would prevent rate shock and unduly rapid transitions for the RLECs, while ensuring an orderly change to the system based on forward-looking costs.

VI. THE COMMISSION SHOULD FURTHER REFORM RLEC INTERSTATE ACCESS CHARGES TO FULLY ELIMINATE IMPLICIT SUBSIDIES

As part of its elimination of ROR regulation of the RLECs, the Commission should seek comment on changes to the interstate access charge rules Specifically, the Commission should consider <u>rate structure</u> rule changes needed to rebalance the rates charged by ROR carriers and eliminate all implicit subsidies embedded in those carriers' interstate access charges <u>91/</u> The Commission should

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<u>91/</u> *See Tenth Circuit Remand Order FNPRM*, ¶ 127 (encouraging states "to replace implicit support with explicit support mechanisms that will be sustainable in a competitive environment") Consistently, the Minnesota Public Utilities Commission recently commenced an inquiry into rebalancing of local rates and intrastate access charges, and related universal service rule changes, in order to eliminate implicit "subsidies that may inhibit the development of viable competition and the benefits it may yield in the form of consumer choice, service quality, efficiency, and as an impetus to technological advance Competitors cannot profitably enter local markets where they bear operation costs higher than the subsidized rates they must meet in order to compete " Statement of Proposed Inquiry, *Commission Investigation of Intrastate Access Charge Reform*, Docket No P-999/CI-98-674, *Universal Service Rulemaking*,

also modify its policies regarding access charge _rate levels_ of ILECs currently subject to ROR regulation. These policy changes should be coordinated with the Commission's broader efforts to reform and harmonize the rules governing inter-carrier compensation.

First, the Commission should significantly increase or eliminate altogether the caps on subscriber line charges ("SLCs"), which preclude ILECs from recovering the full cost of loops from end-users. The Commission has long recognized that ILECs incur loop costs on a non-traffic sensitive basis, that the most economically efficient way to recover those costs is on a non-traffic sensitive basis from the cost-causers (end-users); and that SLC caps constitute an implicit subsidy from access customers (and universal service contributors who pay into the ICLS fund) to end users. The Commission should put an end to such implicit subsidies. This does not necessarily have to lead to an increase in the rates charged to end-users. However, rather than relying heavily on implicit subsidy mechanisms such as SLC caps to ensure that end-user rates are reasonable and affordable, the Commission should instead use forward-looking cost-based universal service support to achieve reasonable end-user rates – but only to the extent needed, and only on a competitively-neutral basis.

Second, the Commission should seek comment on other rate structure changes to eliminate implicit subsidies from the interstate access rate structure,

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Docket No. P-999/R-97-309, *Commission Investigation of Cost for the Appropriate Level of Universal Service Support*, Docket No. P-999/CI-00-829, at p. 2 (issued Oct. 13, 2003) (available at http://www.puc.state.mn.us/docs/stmtofinq.pdf) such as the rule that local switching costs be recovered from long-distance carriers on a traffic-sensitive basis The Commission has recognized that ILECs incur the cost of the "port" component of local switching on a non-traffic sensitive basis, and many parties have argued that the remainder of local switching costs are largely, or possibly entirely, non-traffic sensitive. 92/ If these arguments are correct, then some or all of the local switching charges currently paid by long-distance carriers on a traffic-sensitive basis ought to be paid by end-users on a non-traffic sensitive basis.

Third, the Commission should modify its rules to set ILECs' access charge rate levels – *i e*, the SLCs and switching charges paid by end-users, as well as the local transport and any possible remaining local switching charges paid by long-distance carriers – based on forward-looking costs, rather than embedded costs As the Commission has made clear in recent access charge proceedings, it is possible to assess the reasonableness of access rates based on forward-looking costs 93/ Moreover, the Supreme Court has affirmed that forward-looking economic cost-based rates can be fully compensatory to the ILECs. 94/ Such reform is overdue and should be adopted with respect to all ILEC interstate access charges.

Fourth, with respect to future adjustments in access rate levels, the Commission should consider whether the existing price cap system that applies to

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92/ *See, e g*, AT&T Comments, CC Docket No 02-148, filed July 3, 2002, at 66-69.

93/ *Cost Review Proceeding for Residential and Single-Line Business Subscriber Line Charge (SLC) Caps*, Order 17 FCC Rcd 10868 (2002) (evaluating the forward-looking costs of price cap ILECs loops, and concluding that a substantial proportion have costs in excess of the $6 50 SLC cap)

94/ *Verizon v FCC*, 535 US at 471

non-rural ILECs *should be applied to the RLECs, or whether modifications to that* system might be appropriate Moreover, the Commission should consider whether to adopt pricing flexibility rules comparable to, or different from, the measures that apply to the larger ILECs In particular, it might be appropriate to use the receipt of high-cost support by a competitive ETC as a "trigger" for certain types of pricing flexibility for the RLECs

Finally, access charge issues should be addressed in the context of the pending *Intercarrier Compensation* proceeding. Western Wireless supports the Commission's objective of ultimately reducing all forms of intercarrier compensation to zero, and requiring all carriers to recover revenues from their own customers rather than from other carriers. Eliminating ROR regulation of the RLECs should facilitate the Commission's accomplishment of its goals in this regard In particular, reduction of the excessive access charges collected by the RLECs will eliminate a competitive inequality from the rural marketplace, in that ILECs are entitled to impose tariffed access charges on long-distance carriers, but CMRS carriers are prohibited from doing so Reduction of RLEC access charges will also lead to economic efficiency and should benefit rural consumers, who currently suffer from a severely distorted long-distance and local marketplace

VII. CONCLUSION

For the foregoing reasons, the Commission should take expeditious action to phase out rate-of-return regulation as the basis for small and mid-size ILECs' universal service disbursements and access charges This would serve the public interest far more efficiently –and would control the growth of the fund much more effectively – than some of the anti-competitive proposals that the ILECs have advocated in the *Joint Board Portability Proceeding*. Instead of the antiquated, inefficient, and anti-competitive system of ROR regulation, the Commission should develop a regulatory system based on forward-looking cost.

Respectfully submitted,

WESTERN WIRELESS CORPORATION

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October 30, 2003

Rate of Return Regulation:
Problems That Can No Longer Be Ignored

ATTACHMENT A

to

Western Wireless Corporation's

Petition For Rulemaking To Eliminate Rate-Of-Return Regulation Of Incumbent Local Exchange Carriers

October 30, 2003

Rate of Return Regulation:
Problems That Can No Longer Be Ignored

Rate of Return Regulation: A Failed Model of Economic Regulation

Western Wireless Corporation ("Western Wireless") addresses the theoretical and practical problems that result from using an embedded cost/rate of return methodology to determine universal service funding for smaller incumbent local exchange carriers ("ILECs") in a separate paper, "Rate of Return Regulation: A Failed Model of Economic Regulation," released on June 3, 2003.[1] Western Wireless showed that carriers have both the incentive and ability to manipulate their embedded cost study results to maximize their universal service fund ("USF") and/or interstate access revenue and documented instances in which the Federal Communications Commission ("FCC") has found that carriers have done so. Western Wireless recommended that rate of return regulation for smaller ILECs be replaced by a system in which USF payments to <u>all</u> ILECs are based on forward looking economic costs ("FLEC"). Until such time as an appropriate FLEC model can be developed for smaller ILECs, Western also recommended that the FCC establish a stringent and comprehensive audit program over ILEC embedded cost studies to ensure the integrity of the high cost fund mechanisms.

In this Paper, Western Wireless further documents instances in which ILECs have manipulated their embedded cost studies to maximize their USF and/or access revenue. This time, Western Wireless focused its review on state commission proceedings in which large or small ILEC embedded cost studies were thoroughly scrutinized. State commissions typically conduct more comprehensive audits or reviews of carriers' cost studies than does NECA or the Commission, which, in itself, is a problem and raises the issue of lack of federal oversight of ILEC cost studies It is highly likely that, if conducted by NECA or the FCC, thorough audits of ILECs' USF and access cost studies would reveal problems similar to those identified by the states herein (the problems with the ILECs' federal cost studies would likely be of even greater magnitude given the historic lack of oversight)

The cost studies reviewed for this Paper were submitted in different types of proceedings rate cases, earnings investigations, state universal fund audits, and earnings sharing calculations under alternative regulatory mechanisms The lack of oversight of ILEC cost studies is also a problem at the state level because detailed reviews of carrier cost submissions have become less common in the last few years -- most states no longer regulate the former Bell Operating Companies ("BOCs") on a rate of return basis and many states either no longer or do not actively regulate the local rates of smaller ILECs and/ or cooperatives

The results of Western Wireless' review of state commission proceedings involving ILEC cost studies are striking In virtually all instances, significant problems with the carriers' cost submissions were identified that resulted in disallowances of specific cost items and/or a settlement with the carrier receiving significantly less than originally requested The abuses uncovered included misstated affiliate transactions, failure to fully and accurately identify and allocate nonregulated costs, inclusion of costs that were not related to the provision of regulated services, and accounting misclassifications

Kansas Case Study

In 1998, the Kansas Corporation Commission ("KCC") began a series of audits and general rate investigations of ILECs that received Kansas Universal Fund Support ("KUSF") to ensure that the level of support received by each carrier was based on its costs and that its rates were just and reasonable Many of these proceedings resulted in stipulated settlements with no detailed findings and conclusions, but simply a settlement that required the company to reduce its draw from the KUSF to eliminate excess intrastate earnings

JBN Telephone Company The telephone company claimed a revenue deficiency of $572,917, but after KCC scrutiny of its costs, JBN entered into a settlement agreement that required it to reduce intrastate revenues by $690,000 annually by reducing its draw form the KUSF [2]

Wilson Telephone Company The telephone company claimed a revenue deficiency of $142,459, but reached a settlement with the KCC that required it to reduce intrastate revenues by $148,000 [3]

Craw-Kan Telephone Cooperative The telephone company claimed a revenue deficiency of approximately $300,000, but agreed to reduce its intrastate revenues by $500,000 in a settlement with the KCC [4]

Bluestem and Sunflower Telephone Companies Bluestem and Sunflower are subsidiaries of Fairpoint Communications, a mid-sized holding company [5] One of the principal areas of contention was the management services agreement between the telephone companies and the holding company/service corporation The management services agreement governed the allocation of costs charged to the telephone companies for corporate and management services The findings of the KCC are revealing of the types of issues and problems that can be uncovered by a careful investigation of telephone company costs, including [6]

- Financial advisory fees paid to Fairpoint's investor/owners for advice on equity financing and strategic planning of $1 million were allocated to the telephone companies These were deemed not related to the provision of regulated services

- The cost of stock based compensation ($12 3 million), essentially stock dividends, was allocated to the telephone companies The staff found that "Rate Base rate of return regulation does not recognize dividends as part of the revenue requirement determination, therefore, the inclusion of this charge effectively provides a return to the corporate parent and a return or profit above the authorized return, to the investor "[7]

- Some nonregulated subsidiaries (e g , Fairpoint Solutions) appeared to receive no allocation of corporate costs and some of the proposed allocation factors effectively resulted in no costs being allocated to many nonregulated subsidiaries Some subsidiaries had zero or negative cost allocations

- Historically, management fee allocations were based on revenues, which do not necessarily reflect cost causation

- It was left to the General Manager's discretion to determine which accounts should be charged the management fees, potentially compromising the integrity of the companies' accounts

The KSS staff's recommendation was that only $10 6 million of Fairpoint's corporate costs should be allocated to its operating companies, compared to the $34 2 million Fairpoint had allocated for its 2000 test year Under the settlement agreement reached with Bluestem and Sunflower, the telephone companies were required to reduce their draw from the KUSF to zero

Southern Kansas Telephone Company In its review of Southern Kansas' cost studies, the KCC uncovered other ingenious attempts a misallocation of costs, including [8]

- Southern Kansas claimed deferred income tax asset included the effects of tax timing differences related to nonregulated expenses

- Southern Kansas claimed depreciation expense on plant that had been fully depreciated

- Southern Kansas failed to reflect a known and measurable increase in federal USF for the period when KUSF would be paid and rates would be in effect

- Payments to a consulting group that focuses on family relationships and the dynamics of families working together had not been shown to benefit regulated ratepayers

In the end, the KCC found that Southern Kansas had over earnings in excess of $2,828,214

Rural Telephone Company The KCC found the following transgressions on the part of Rural Telephone Company [9]

- Claimed more property tax expense than it had actually paid during the test year

- Calculated its depreciation expense on its largest outside plant accounts using depreciation rates in excess of those permitted by the KCC

- Included lobbying and corporate image advertising expenses, costs that benefit the company, not the regulated ratepayer

As a result of these, and other adjustments, the KCC found that Rural had excess intrastate revenues of $801,533

California Case Study

The California Public Utilities Commission's (CPUC) Office of Ratepayer Advocates (ORA) conducted an extensive audit of the affiliate and nonregulated transactions of Roseville Telephone Company ("RTC") and uncovered the following improper allocations of costs [10]

- RTC's CEO, CFO and their staffs had allocated only 8 out of 31,000 hours to affiliate and nonregulated operations
- RTC's VP of marketing had done some work for Roseville Cable, but the costs were not properly assigned to Roseville Cable
- RTC failed to assign any accounting, budget and finance development costs and the revenue accounting manager's time to Roseville Long Distance.
- RTC had allocated its information services costs based on out of date and incorrectly developed end user service order, payment and collection factors that underallocated RTC's computer infrastructure costs to affiliates and unregulated operations
- The cost of a valuation study related to the transfer of RTC's wireless interests to an unregulated affiliate were charged to RTC
- RTC failed to bill Roseville Cable for regulatory costs incurred for Roseville Cable
- Alarm Monitoring costs were inappropriately booked in RTC's regulated accounts
- Employee health insurance costs for an unregulated affiliate were paid by RTC
- RTC had booked the costs of institutional and goodwill advertising in its regulated accounts, in direct contravention of CPUC policies
- RTC failed to bill a substantial portion of the costs to establish its long distance affiliate to that affiliate
- RTC charged its wireless affiliate a market rate for office space rather than a fully distributed cost based rate as required by the CPUC